Nos. 12,728 and 12,729

IN THE

United States Court of Appeals

For the Ninth Circuit

ROLLINGWOOD CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DAVID D. BOHANNON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petitions for Review of Decisions of the Tax Court of the United States.

REPLY BRIEF FOR PETITIONERS.

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REPLY BRIEF FOR PETITIONERS.

All of the facts in these cases are stipulated.

On the facts, Respondent is in an impossible position; hence, his brief,—based upon many assumptions and inferences not possible within the record,—attempts to ignore determinative facts which Respondent has stipulated.

Petitioners' position requires only,—and of course Petitioners will receive,—a determination of the issues on the facts and only those inferences founded upon the facts.

The impact of World War II can not be ignored as Respondent has attempted to do. The issue in these cases is not what Rollingwood Corporation would have done if World War II had not occurred, but on the contrary the issue is what Rollingwood Corporation in fact did do because of World War II, the requirements of the United States Government for rental housing and the policies and requirements of the United States Government in connection therewith. In fact Rollingwood Corporation would probably never have existed but for World War II and the requirements of the United States Government for rental housing.

Likewise what Mr. Bohannon would have done but for the occurrence of World War II, what he did prior to World War II and what he did after World War II are not of any significance whatever. The Respondent has stipulated (Stip. ¶ 35; R. 40) that Mr. Bohannon shortly after Pearl Harbor disbanded his sales force and thereafter maintained no sales force; and thereafter engaged in no advertising and in no land development or sales programs and that during all times here involved Mr. Bohannan devoted substantially his entire time and attention to the war housing project of Rollingwood Corporation and other war housing projects.

If World War II had not occurred Rollingwood Corporation (if it be assumed that it would have been or-

ganized if the war had not occurred) or Mr. Bohannon: (a) might have built houses for sale rather than for rental; (b) might have been able to obtain materials for the construction of houses without having to obtain priorities from a War Production Board; (c) might have operated a business similar to Mr. Bohannon's prewar business without restrictions placed upon the sale of houses by the National Housing Agency or the War Production Board; (d) might have placed "For Sale" signs rather than "For Rent" signs on houses built for sale; (e) might have advertised houses for sale rather than for rent; and (f) might have sold houses rather than rented them in accordance with an announced and advertised intention and in conformity to the policies of the United States Government. But these are not the facts of these cases nor should inferences be drawn from what might have been.

On the contrary the facts, in addition to showing such change in Mr. Bohannon's business, also show:*

(1) Rollingwood's private War housing project was initiated by a most critical War industry and not by Rollingwood Corporation or Mr. Bohannon. (R. 24, 25, 26.)

(2) This project was undertaken and completed in accordance with the policies of the United States Government to encourage the construction of defense houses for rent. (R. 26, 27.)

*These facts speak for themselves, and show the total lack of similarity between the cases now before this Court and the facts of *Rubino v. Commissioner*, ... F. (2d) ..... Nos. 12,535-12,536 (decided January 2, 1951), 1951 P.H. Tax Service, Vol. 4, ¶72,225.

(3) The conditions imposed by the U. S. Government on the issuance of priorities and the agreements made by Rollingwood Corporation with the United States Government in connection with such priorities required the rental of said houses. (Exhibits 1 and 3.)

(4) Rollingwood Corporation displayed on the construction site of this project two large signs setting forth the rent of these houses as a rent of $50.00 per month. (R. 34, 35.)

(5) Rollingwood Corporation conspicuously advertised these houses "For Rent—$50.00 a month New 3-Bedroom Homes." (R. 35.)

(6) Rollingwood Corporation's rental expenses included $5,432.53 for advertising in the years 1944 and 1945. (Exhibit 16, Stip. ¶ 30, R. 39.)

(7) Rollingwood Corporation, in fact, immediately rented all of said houses. (R. 32-34.)

(8) Rollingwood Corporation not only committed itself in writing to a thirty months rental of each of said houses, but also by granting an exclusive option to purchase to each of its tenants, placed its power to sell each of said houses beyond its control for thirty months, except to one person, i.e., the tenant thereof. This then eliminated all of the other possible purchasers within the market to whom such houses might have been sold. (R. 32-34, 44, 45.)

(9) Rollingwood Corporation rented these houses for an average period of 22.9 months. (R. 32, 37, 38, Exhibit 11 and computations therefrom.)

(10) Rollingwood Corporation was a successful rental enterprise financially. (Exhibit 16, Stip. ¶ 30, R. 39.)

(11) Rollingwood Corporation never displayed any "For Sale" signs on any of said houses nor on the Rollingwood tract. (R. 35.)

(12) Rollingwood Corporation never had any sales force for the purpose of selling said houses. (R. 36.)

(13) Rollingwood Corporation, following the completion of the construction of its project, on August 14, 1943, never engaged in any developmental activity with respect to the Rollingwood tract or said project, and never subdivided, nor otherwise improved any of its properties. (R. 32, 35, 36.)

Not only has Respondent sought to have this Court ignore all of the foregoing facts and circumstances, but in addition and without any explanation Respondent has also represented to this Court that based upon Schedule C of each of the tax returns of Rollingwood Corporation, the expenses of the sale of houses by Rollingwood Corporation in the years 1944, 1945, 1946 and 1947 were, respectively, $344.17, $52,293.02, $320,085.81 and $57,755.48.

The facts and the only facts shown in the Record, are that these expenses consisted of credits allowed to purchasers on the purchase price of houses by reason of rent previously paid and so allowed in accordance with the lease-option agreements under which such houses were rented, and such necessary adjustments as were charged to the purchaser at the time of sale for insurance, taxes, interest, etc., and because of the transfer to the purchaser

of the F.H.A. reserve fund created by Rollingwood Corporation for taxes and insurance. Respondent's representation is untenable in the face of the note at the bottom of Schedule C of the 1945 return (a similar note appears at the bottom of Schedule C to the 1946 and 1947 returns) which reads as follows:

> "Consistent with the prior year taxpayer has reported as adjustment to the sale price miscellaneous items charged to purchaser of property at time of sale, i.e., insurance, taxes, interest, etc., and for allowances given purchaser for rentals paid by purchaser during occupancy under option to buy agreement and for F.H.A. reserve fund for taxes and insurance taken over by purchaser at time of sale."

Because the Record contains no facts to support Respondent's position, he then leaps to the conclusion that Rollingwood Corporation was unprofitable as a rental enterprise. Besides the doubtful relevancy of this alleged fact, Respondent's conclusion is too hastily drawn.

In the first taxable year of its existence (a period of approximately 9½ months), Rollingwood Corporation's gross rental income was $343,766.07, while its expenses were only $338,095.03. In this first year it realized a net profit of $5,671.04 after having deducted all other expenses of any kind or nature, including:

1. All interest payments on borrowed money, i.e., the sum of $111,206.79.
2. A depreciation expense amounting to $66,480.10. (Exhibit 16, Stip. ¶ 30, R. 39.)

In its second fiscal year, ended May 31, 1945, Rollingwood Corporation's gross rental income was $338,683.87

while its expenses declined to only $315,496.79. In this year it realized a net profit from rental activities of $23,187.08, after having deducted all other expenses of any kind or nature, including:

1. All interest payments on borrowed money, i.e., the sum of $111,704.89.

2. A depreciation expense amounting to $65,984.96. (Exhibit 16, Stip. ¶ 30, R. 39.)

To fairly appraise the investment value and profit potential of such an enterprise, it would be necessary to project these results over a substantial number of years. If, at the end of its second fiscal year ended May 31, 1945, and if it were assumed that the rental expenses of Rollingwood Corporation would remain as high as in 1945 (which would be highly improbable), and if its future were projected for 30 years on the basis of its 1945 experience (the useful life of these houses stipulated to have been built of good materials and to have provided permanent housing facilities would extend more than 30 years) then it would be reasonable to conclude that over such thirty-year period:

The gross income from rental operations would be	$10,160,516.10
The gross expenses of all kinds would be	9,464,903.70
The net profit would be	695,612.40
The reserve for depreciation would be	1,979,548.80

and Rollingwood Corporation (except for any forced disposition of its houses through the exercising of any ten-

ant's exclusive option to purchase) would still have been the owner of these houses.*

YET RESPONDENT ARGUES AND CONCLUDES THAT THE COST OF THIS RENTAL PROJECT WAS OUT OF ALL PROPORTION TO ANY POSSIBLE GAIN!

Very appropriate here are the remarks of Judge Johnson in the case of *Julia K. Robertson,* .....TC....., P-H TC Memo Par. 49234 (1949) (cited by Petitioners herein only for its reasoning rejecting a similar argument since it is a factually different case from this one) as follows:

> "All circumstances concerning the acquisition and use of these properties in the taxable years stamp them as rental or investment property and not property held primarily for sale.
>
> "Respondent's adverse conclusion is based largely upon assumptions and deductions. He contends: (a) since it appears that petitioner derived a larger percentage of profits from sales than from rentals 'it is not reasonable to assume' that he would borrow over a million dollars to receive a small rental income rather than a 'reaping of profits' from sales; (b) that petitioner, prior to 1943, having been profitably engaged in building houses for sale, except for the fact that he 'had no other alternative' would not have changed his business to that of rental; and (c) petitioner's 1946 resumption of building for sale indicates that in the taxable years he was holding the

*The foregoing computations are based on Exhibits 16 and 22. In Exhibit 16 the Expense item "Real estate taxes" was adjusted by a reduction of $4,968.60 shown as a "Correction of Estimate of Real Estate Taxes" on Exhibit 16, and as shown on the Amended Return, Exhibit 22.

property for sale, and cites Neils Schultz, 44 BTA 146, where the taxpayer, after renting the property for some years before selling it, was nevertheless found to have held the property primarily for sale. There, however, the sale involved property sold in the taxable years, and not subsequently. There also the Court found specifically that the taxpayer 'acquired the land to be held for sale to customers' and the evidence here justifies no such finding.

"It matters not whether petitioner, from necessity or from choice, changed his business in the taxable years from building houses for sale to building them for rent. The question is, did he make such change, and the evidence shows that he did. Many individuals in the war years changed the kind of business in which they were engaged. In some instances the ratio of profits were larger, and in others smaller, but as patriotic citizens they cooperated, regardless of results. A vast majority of them also, when the war ended, resumed the same business in which they had been theretofore engaged, as did the petitioner." (Emphasis added.)

Respondent has further confused and treated as comparable (a) Rollingwood Corporation's rental business as it existed during its second fiscal year and (b) Rollingwood Corporation's rental business as it existed after 221 of its tenants had forced it to dispose of 221 of its houses by each such tenant exercising his exclusive right to purchase the house in which he resided.

Rollingwood Corporation during its first two fiscal years was a large rental housing project, and a highly profitable one.

In its third fiscal year ended May 31, 1946 (this entire year being after V-E Day and 9½ months of it after V-J Day), 221 of Rollingwood Corporation's tenants forced the sale to them of 221 houses by each such tenant exercising the option to purchase the house in which he resided. (Stip. ¶ 28, R. 37 and 38, Exhibit 11 and computations therefrom.)

Rollingwood Corporation during its last two fiscal years was neither a large rental housing project nor a profitable one.

This post-war action of the tenants could not have been foreseen (only 7.1% of the options were exercised during the War), especially since tenants were in-migrant war workers. (Stip. ¶ 28, R. 37, 38, Exhibit 11 and computations therefrom.)

At the time these options were granted, in 1943, World War II was in a very critical condition. It is common knowledge that it was then generally believed the War would continue for many years.

It is obvious that so long as Rollingwood Corporation had a large number of houses to rent its gross rental income was gigantic and it was profitable. But when, due to conditions beyond its control, it ceased to be either a large or a profitable rental business, it was forced to sell itself out of the rental business, and to convert capital assets into cash.

Respondent's brief, concerned with vague generalities and not with the specific basic issue of these cases, in addition to its erroneous assumptions and inferences above and beyond the Record, concedes the specific propo-

sition, both of fact and of law, established in Petitioner's Brief that Rollingwood Corporation disposed of the capital assets involved in these cases (houses built for and devoted to rental purposes), under circumstances which in view of the decisions of the Tax Court and of this Court would not convert these capital assets into assets held primarily for sale to customers in the ordinary course of business, i.e., in the sale thereof by Rollingwood Corporation, it:

(a) never engaged in any activities to promote sales;

(b) never displayed any "For Sale" signs on any of the properties involved;

(c) never maintained any sales force for the purpose of selling said properties;

(d) never engaged in any developmental activities of any kind or nature after the rental thereof. (Stip. pars. 21, 25, R. 32, 35, 36.)

The decisions of this Court to which Respondent refers (*Richards v. Commissioner,* 81 F. (2d) 369, and *Ehrman v. Commissioner*, 120 F. (2d) 607), have no applicability here because they very properly dealt with situations entirely different from that here presented.

The law of taxation, involving all phases of economic activity, has not developed into the comprehensive body of law which it is today by such vague generalities. It has developed by the process of literally thousands of Court decisions establishing on which side of the line should fall cases involving facts similar in some respects to, but different in other respects from those of previous cases.

This case is not like the *Ehrman* and *Richards* decisions for all of the reasons set forth and upon all of the authority cited in Petitioners' Brief (pages 33-50). Respondent does not attempt to meet either the reasons or the authority there set forth.

His attempts to read the word "primarily" out of the Statute altogether are without merit. First to Respondent "primarily" means "essential." After taking this step, he jumps from "essential" to "substantial."

In the *Richards* case this Court was very careful to follow closely the language of Section 117 of the Code itself when it decided that the word "held" was a more inclusive term than the word "purchase," despite very strong Congressional history to the contrary, which appears in the opinion of that case at page 372 as follows:

> "It is apparent from this quotation that Congress considered or perhaps contemplated lowering the tax for those owners 'who sell property not primarily purchased for the purpose of resale.'"

This Court in these cases should, we believe, follow the statutory language upon which these cases are to be decided (as it did in the *Richards* case), and consequently should refuse to emasculate Section 117 by obliterating the word "primarily."

In the decisions of this Court and in the decision of the United States Court of Appeals for the Eighth Circuit, *Albright v. U. S.*, 173 F. (2d) 339 (1949), it is obvious that the courts have given the words "primarily for sale to customers in the ordinary course of business" their full meaning and not an emasculated one, which is in full

accord with the legislative history of this statute. Furthermore, a contention made by the Respondent similar to that which he is making in these cases was expressly rejected in *U. S. v. Bennett,* ..... F. (2d) ....., January 8, 1951, Prentice-Hall 1951 Federal Tax Service Volume 4, paragraph 72,227, wherein the Court held:

> "If the statute had been intended to mean what the collector contends for, the word 'primarily' would not have been in it. Since 'primarily' is in the statute, it seems clear to us that to hold, as the collector contends, that the main, the first, purpose of the keeping of these breeder cattle was for sale, does complete violence to the statute and to its purpose and intent." (Emphasis added.)

Property "held by the taxpayer primarily for sale in the course of his trade or business" has been excluded from the definition of capital assets since the Revenue Act of 1924 (C. 234, 43 Stat. 253, Section 208).

"Property held by the taxpayer primarily for sale in the course of his trade or business" by the 1924 Act, was excluded from the definition of capital assets in order to plug a loop hole in the Revenue Act of 1921 (Section 206, C. 136, 42 Stat. 227). Under the 1921 Act (which first established in this country the "capital gain" method of taxation not theretofore used in this country) property of a kind which would properly be included in the taxpayer's inventory was excluded from the definition of capital assets and there was doubt whether real property, when it constituted economically the "inventory" of a taxpayer, could properly be included in the term "inventory" from an accounting standpoint. The

intent of Congress in passing the 1924 Act was to make certain that "dealer" real estate, like the "inventory" of a retailer or manufacturer of goods, would be excluded from the capital gain method of taxation. H.R. No. 179, 68th Cong., 1st Sess., p. 19, 1939-1 Cum. Bull. (Part 2) 255, and S.R. No. 398, 68th Cong., 1st Sess., p. 22, 1939-1 Cum. Bull. (Part 2) 281. This doubt was well founded because in the *Keeney* case, 17 BTA 560, the Board held a real estate dealer not excluded from the capital asset method of taxation (under the 1921 Act) because real property should not properly be included in taxpayer's inventory.

The Revenue Acts of 1938 (C. 289, 52 Stat. 447) and 1942 (Section 151, C. 619, 56 Stat. 798) have absolutely nothing to do with the question before this Court. The 1938 Act, as a relief measure excluded business property subject to depreciation from the loss limitations (and as a corollary from the gain benefits) upon the sale of capital assets. Property held primarily for sale to customers in the ordinary course of business, however, was already excluded by the 1924 Act.

As a relief measure the 1942 Act restored the capital gain benefits to the sales of business property subject to depreciation, but substantially left intact the benefits derived from the removal of the capital loss limitations on the sale of such property established by the 1938 Act. Here again the 1942 Act had absolutely nothing to do with property held primarily for sale to customers in the ordinary course of business, i.e., "dealer" property, because this type of property was already, and since 1924 always has been, excluded from the capital gain or loss provisions of Section 117. Nothing in the legislative his-

tory of these Acts is to the contrary. Furthermore the effect of (a) the 1934 Act (Section 117, C. 277, 48 Stat. 640) wherein the "dealer" exception was changed to "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"; (b) the relief measure of the 1938 Act; (c) the relief measure of the 1942 Act, and (d) the reduction of the capital gain "holding period" from 2 years in 1924 to a nominal 6 months period by the 1942 Act, constitute the real history of this period and, if anything, show an increasingly liberal attitude of Congress towards the capital gain method of taxation and a total absence of any intent to narrow the definition of capital assets.

Petitioners submit that they have met their burden of proof in these cases, and have conclusively established that these 700 houses were constructed and built for rental and never held primarily for sale to customers in the ordinary course of business. Petitioners submit that this Court should, upon two separate principles, either (a) independently review whether these houses were ever held primarily for sale to customers in the ordinary course of business within the meaning of Section 117 (j) as a matter of law based upon evidentiary facts which are without conflict, or (b) reach its own conclusions of fact without regard to the findings of fact of the Tax Court because all of the evidence in these cases has been stipulated in writing.

Respondent cites the *Richards* case, 81 F. (2d) 369, as being opposed to the first principle, but has ignored *Commissioner v. Boeing,* 106 F. (2d) 305, overruling the *Richards* case on this point. The United States Court of Ap-

peals for the Seventh Circuit also has held this issue to be one of law for the appellate court to determine. *Three States Lumber Company v. Commissioner,* 158 F. (2d) 61 (1946).

As opposed to the second principle, Respondent states, without any authority, that the question in these cases is whether there is evidence to sustain the finding of the Tax Court. The following Courts disagree with Respondent's statement:

This Court—

Equitable Life Assurance Society v. Irelan, 123 F. (2d) 462 (1941);

This Court—

Pacific Portland Cement Co. v. Food Machinery Corp., 178 F. (2d) 541 (1949);

The United States Court of Appeals for the Second Circuit—

Orvis v. Higgins, 180 F. (2d) 537 (1950), cert. denied 340 U.S. 810;

The United States Court of Appeals for the District of Columbia—

Dollar v. Land, 184 F. (2d) 245 (1950);

The United States Court of Appeals for the Seventh Circuit—

Wigginton v. Order of United Commercial Travelers, 126 F. (2d) 659 (1942), cert. denied 317 U.S. 636;

The United States Supreme Court—

United States v. United States Gypsum Co., 333 U.S. 364, at 394 (1948).

We also note Respondent's failure, along with that of Honorable Marion J. Harron, the judge who decided these cases on behalf of the Tax Court, to discover any ground of distinction between these cases and the *Elgin Building Corporation* case, ... TC ....., par. 49,015, P-H TC Memo (1949), stated in Petitioners' Brief to have been in twelve respects identical with the facts of these cases, in four respects weaker than the facts of these cases, and in no respects distinguishable.

Dated, San Francisco, California,
March 31, 1951.

Respectfully submitted,
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